

**Testimony of
Anthony J. Kamerick**

1 **DELMARVA POWER & LIGHT COMPANY**
2 **TESTIMONY OF ANTHONY J. KAMERICK**
3 **BEFORE THE DELAWARE PUBLIC SERVICE COMMISSION**
4 **CONCERNING AN INCREASE IN ELECTRIC BASE RATES**
5 **DOCKET NO. 11-528**
6

7 **1. Q: Please state your name and position, and business address.**

8 A: My name is Anthony J. Kamerick. I am Senior Vice President and Chief
9 Financial Officer of Pepco Holdings, Inc. (PHI). I am testifying on behalf of
10 Delmarva Power & Light Company (Delmarva or the Company), located at 401
11 Eagle Run Road, Newark, DE 19702.

12 **2. Q: Please state your educational background and professional qualifications.**

13 A: I hold a Bachelor of Science degree in Accounting from the University of
14 Maryland and a Master of Business Administration with a concentration in
15 Finance and Investment from George Washington University. I have also
16 successfully completed the University of Michigan's Public Utility Executive
17 Program.

18 I joined Potomac Electric Power Company (Pepco) in 1970 and have
19 served in various positions of increasing responsibility, including Manager,
20 Revenue Requirements and Director, Budgets and Financial Planning. In 1982, I
21 was elected Assistant Treasurer of the Company and in 1983, I was elected
22 Assistant Comptroller. From 1985 through February 1988, I served as Treasurer
23 of Pepco's then-principal subsidiary, Potomac Capital Investment Corporation
24 (PCI). I was elected Vice President and Treasurer of PCI in September 1986. I
25 was reassigned to Pepco and elected Assistant Comptroller in March 1988, and

1 elected Comptroller in April 1992. In May of 1994, I was elected Vice President
2 and Treasurer of Pepco. Following Pepco's merger with Conectiv, and the
3 formation of PHI as the parent of Pepco and Conectiv in August 2002, I was
4 elected to the additional position of Vice President and Treasurer of PHI. In
5 March 2009, I was promoted to Senior Vice President and Chief Regulatory
6 Officer. In June 2009 I was elected PHI's Senior Vice President and Chief
7 Financial Officer.

8 I am a member of the District of Columbia Chapter of Financial
9 Executives International and a past President of the Chapter and Board member.
10 In addition, I am a member of the National Association of Rate of Return
11 Analysts and a former member of the Edison Electric Institute Accounting
12 Research Committee and the Budget and Financial Forecasting Committee. I also
13 serve on the Board of Directors of Montgomery Alliance for Community Giving,
14 the Board of Directors of the Community Services for Autistic Adults and
15 Children Foundation, and the Board of Trustees of Studio Theatre.

16 3. Q: **What are your responsibilities in your role as Senior Vice President and**
17 **Chief Financial Officer?**

18 A: I am responsible for all financial matters related to PHI and its three
19 regulated utility subsidiaries, including Delmarva. My responsibilities include:
20 accounting and financial reporting; treasury operations; pension administration;
21 strategic planning; and investor relations. I am also the senior officer responsible
22 for regulatory matters that come before the state commissions and the Federal
23 Energy Regulatory Commission (FERC). Prior to my election as Chief Financial

1 Officer, I was PHI's Senior Vice President and Chief Regulatory Officer, and
2 prior to that, PHI's Vice President and Treasurer. In the latter capacity, I was
3 responsible for managing PHI's relationship with the financial community and
4 served as the primary contact with credit rating agencies.

5 **4. Q: Have you recently testified before the Delaware Public Service Commission?**

6 A: Yes, I have. I have recently presented testimony as a Witness before the
7 Delaware Public Service Commission (DPSC or the Commission) in the
8 Company's most recent base rate proceeding, Docket No. 09-414, as well as
9 testimony before the Maryland Public Service Commission, the New Jersey
10 Board of Public Utilities, the Public Service Commission of the District of
11 Columbia, and the Federal Energy Regulatory Commission.

12 **5. Q: What is the purpose of your testimony?**

13 A: The purpose of my testimony is to (A) provide an overview of the
14 Company's application for an increase in base distribution rates; (B) briefly
15 summarize the testimony of the Company's witnesses; (C) discuss the shortfall in
16 earnings and the Company's proposed mechanisms to mitigate the regulatory lag
17 caused by current regulation; and, (D) discuss the importance of Delmarva
18 remaining a financially sound utility with investment grade credit ratings.

19 The testimony was prepared by me or under my direct supervision. The
20 source documents for my testimony are Company records, public documents, and
21 my personal knowledge and expertise.

1 **6. Q: Please describe the Company's Application.**

2 **A:** This filing consists of the application for an increase in base distribution
3 rates, together with my testimony and that of 12 other witnesses. As described
4 more fully below, those witnesses and the topics they address are as follows:

- 5 • Dr. Mark N. Lowry, President, Pacific Economics Group Research and Senior
6 Advisor to Pacific Economics Group will provide testimony on the issue of
7 chronic under-earning. He also discusses several approaches to address the
8 mitigation of under-earning that are being used effectively in other
9 jurisdictions and recommends that the Commission adopt a Reliability
10 Investment Recovery Mechanism (RIM) and make a prospective change of
11 Commission's Order No. 5410 that will allow the use of fully forecasted test
12 periods in future rate cases.
- 13 • Ms. Julie M. Cannell, President, J.M. Cannell, Inc. will present testimony
14 from the view of prospective investors. Specifically, she will provide the
15 investors' views on investment risks, regulatory outcomes and regulatory lag.
- 16 • Mr. Robert B. Hevert, President, Concentric Energy Advisors, Inc., provides
17 testimony and schedules in support of the Company's proposed cost of equity.
- 18 • Mr. Kevin M. McGowan, Vice President and Treasurer, provides testimony
19 and Schedules addressing the appropriate capital structure and embedded cost
20 of debt for Delmarva, which along with Company Witness Hevert's cost of
21 equity, are used to arrive at the appropriate overall rate of return for
22 Delmarva. Company Witness McGowan also discusses how the Company's
23 2012 estimated cost of service was developed.

- 1 • Mr. Gary Stockbridge, President, Delmarva Region, will present testimony
2 addressing the Company's role in the community and the implication of
3 Delmarva's financial health on its customers.
- 4 • Mr. W. Michael VonSteuben, Manager, Regulatory Requirements, will
5 provide testimony and schedules in support of the Company's results of
6 operations, including rate base, operating revenue, and operating expenses. He
7 will also provide testimony and schedules in support of the Company's
8 revenue requirement, the test year selection, and the proposed ratemaking
9 adjustments. Company Witness VonSteuben also sponsors the Company's
10 cash working capital study. In addition, he will provide evidence that the
11 Company is currently and will continue to experience exceptional levels of
12 regulatory lag during the rate effective period.
- 13 • Mr. Jay C. Ziminsky, Manager, Revenue Requirements, provides testimony
14 and schedules related to certain adjustments used to develop Delmarva's
15 revenue requirement. He will also address the ratemaking implications
16 associated with the Company's Advanced Metering Infrastructure (AMI)
17 program.
- 18 • Ms. Kathleen A. White, Assistant Controller, provides testimony on the
19 Company's accounting books and records; PHI's costing and accounting
20 procedures; and accounting policy changes affecting the Company.
- 21 • Mr. William M. Gausman, Senior Vice President, Strategic Initiatives,
22 provides testimony on the AMI program and presents the RIM. He also

1 provides testimony on the Company's construction program, as well as
2 support for certain ratemaking adjustments.

3 • Mr. Charles R. Dickerson, Vice President, Customer Care, provides testimony
4 on the programs that have been initiated to improve the Company's customer
5 service through the addition of staff and technology solutions.

6 • Mr. Elliott P. Tanos, Manager, Cost Allocation, provides testimony and
7 schedules in support of the Company's cost of service studies.

8 • Ms. Marlene C. Santacecilia, Senior Regulatory Affairs Analyst, Rate
9 Economics, provides testimony and schedules in support of the proposed rate
10 design and Delmarva's proposed tariffs.

11 7. Q: What are some of the key elements of the Company's request?

12 A: In addition to providing a detailed cost of service study for Delmarva's
13 electric distribution business in Delaware, the Company provides testimony that
14 addresses the impact of regulatory lag and discusses several mechanisms that are
15 used in jurisdictions around the country to help mitigate the effects of regulatory
16 lag. Through the Direct Testimony of Company Witness Lowry, the Company
17 provides an in-depth discussion on the RIM, multi-year rate plans, fully
18 forecasted test years, and other remedies for chronic under-earning that are widely
19 used by regulators today. All of these measures are designed to mitigate under-
20 earning without diminishing the Commission's oversight authority and, in most
21 instances, have precedent among state utility commissions around the country.

1 8. Q: Has the Company requested recovery of all costs associated with AMI in this
2 filing?

3 A: No, the Company has not requested recovery of all costs associated with
4 AMI in this filing. The Company's requested revenue requirement does include
5 capital costs related to AMI that were placed into service by the end of the test
6 period. These AMI related assets generally consist of the meters and
7 communication equipment required to establish two way communications to our
8 customers. These facilities are in service and are being used to generate customer
9 bills and to provide customers access to valuable energy usage information in
10 order to help customers to understand how they are using energy. As Company
11 Witness Ziminsky states in his Direct Testimony, the Company's cost of service
12 correspondingly reflects a lower level of meter reading expense as compared to
13 the level approved in the Company's last case, Docket No. 09-414.

14 The Company is proposing a phase-in of the remaining costs and benefits
15 that are recorded in the regulatory assets associated with AMI. The proposed
16 phase-in will coincide with certain milestones. The specific details associated
17 with the proposal regarding AMI are covered in more detail in the Direct
18 Testimonies of Company Witnesses Gausman and Ziminsky.

19 9. Q: Please summarize the reasons for Delmarva's rate increase request.

20 A: Delmarva is requesting a \$31.760 million increase in its Delaware
21 distribution rates (a 5% increase in a typical residential customer's bill), because
22 the Company is not currently earning the rate of return authorized by the
23 Commission in Docket No. 09-414 on either an unadjusted or an adjusted basis,

1 as is shown in the Direct Testimony of Company Witness VonSteuben. The
2 Company is seeking to increase its distribution rates in order to provide it an
3 opportunity to earn the authorized return during the rate effective period. The
4 requested increase is required in order for the Company to have the ability to
5 continue to provide safe and reliable service at the lowest cost over the long run.
6 Without an opportunity to earn its authorized rate of return, Delmarva will be at a
7 disadvantage in competing for capital on reasonable terms with other firms in the
8 capital markets, which will work to the disadvantage of Delaware customers in
9 the long run because of the resulting increased capital costs.

10 The Company is requesting an increase in the authorized return on equity
11 (ROE) from 10.00% to 10.75%. This return on equity is fully justified based on
12 the cost of capital study conducted by Company Witness Hevert.

13 10. Q: Why is the Company requesting a 10.75% rate of return on equity?

14 A: The Company is requesting an ROE of 10.75% based on the cost of capital
15 study conducted by Company Witness Hevert, who has demonstrated that to
16 authorize a lower return would not adequately compensate the Company's equity
17 investors for the risk that they are undertaking, and therefore would place the
18 Company and PHI at a disadvantage relative to comparable companies competing
19 for capital.

20 11. Q: Why is it necessary for Delmarva to apply for a rate increase ten months
21 from the Commission's most recent rate order?

22 A: The Company is seeking an increase in distribution rates because its
23 revenue growth has not kept pace with the growth in rate base-related costs and

1 operating costs and this situation will only get worse. As the Commission is
2 aware, the rate setting process should be forward-looking, that is, the rates set in
3 this proceeding should be designed to afford that opportunity to earn the
4 authorized rate of return during the period they are in effect. This is a well-
5 established principle of rate making. Adequate rates for the future cannot be based
6 solely upon a historical or partially forecasted test period, particularly a test
7 period that uses an average rate base and does not recognize in rates known and
8 measurable changes in cost rates. This is especially true in today's environment,
9 when utility rate base-related operating and capital costs are growing at a more
10 rapid rate than is revenue between rate cases. Under such circumstances, rates set
11 using historical or partially forecasted test periods fail to give the Company an
12 opportunity to earn the rate of return authorized by the Commission.

13 The most recent case (Docket No. 09-414) was largely based on costs
14 incurred during a test period ended March 31, 2009, almost three years ago. As I
15 noted above, Delmarva is not currently earning the ROE authorized in that case.
16 In fact, Delmarva's earned return on equity in the proposed test period in this case
17 is only 4.43%, 557 basis points below the authorized rate of return on equity.
18 This significant shortfall, in conjunction with shortfalls in each of the past several
19 years, is very clear proof that the process currently being used to set the
20 Company's rates is not providing a realistic opportunity for the Company to
21 actually earn the rate of return authorized. This under earning has become a
22 chronic problem, as demonstrated in Table 1 of Company Witness VonSteuben's
23 Direct Testimony.

1 12. Q: Why is the growth in distribution rate base outpacing the growth in
2 distribution operating income?

3 A: The growth in rate base is being driven by the need to replace
4 infrastructure, to enhance the reliability of the distribution system, and to provide
5 for future growth in customer usage. Company Witness Gausman discusses the
6 details of the Company's construction budget in his Direct Testimony in this
7 proceeding, including reliability-related investments. As shown in Table 4 of
8 Company Witness Gausman's Direct Testimony, Delmarva's budgeted reliability
9 capital expenditures for 2012 exceed the 2011 level by \$15 million or nearly 36%.
10 Unlike expenditures made to connect new customers, these investments do not
11 produce additional revenues.

12 The increased distribution revenues resulting from growth in the number
13 of customers and kilowatt-hour sales are not sufficient to provide the Company an
14 opportunity to earn its authorized ROE, given the pace of its rate base-related
15 operating and capital expense growth. Clearly, the Company's revenues need to
16 grow at a faster pace in order to allow Delmarva to fully recover operating
17 expenses and have an opportunity to recover the costs associated with the faster
18 growing rate base-related expenses. The Company will need higher distribution
19 rates to allow revenue to keep pace with growing rate base related operating and
20 capital costs and it is seeking a 5% increase in overall bills in this case.

21 Even with the rate increase requested in this case, the cost of providing
22 distribution service will remain very reasonable. In fact, assuming the full
23 requested increase is approved, the daily cost of delivery for the average

1 residential customer using 1,000 kilowatt-hours a month will only be \$1.37, a
2 very good value.

3 The growth in Delmarva Power's revenue is driven by the growth in its
4 number of customers, which has averaged 0.7% over the last five years (2005-
5 2010) and is projected to average 1.3% over the next five years (2010-2015). The
6 increased revenues resulting from the 1.3% growth in customers is not sufficient
7 to provide the Company an opportunity to earn its authorized ROE, given the pace
8 of its rate base-related operating and capital costs.

9 **13.Q: Why is it that current ratemaking cannot provide a reasonable opportunity**
10 **for Delmarva Power to earn its authorized rate of return?**

11 **A:** Current ratemaking assumes that growth during the rate-effective period
12 of the Company's billing determinants (i.e. growth in the number of customers)
13 will provide adequate growth in revenue to cover the growth in capital and
14 operating expenses. In today's environment of low customer growth, this is a
15 false premise. The Company is going through a period of a significant step up in
16 costs to improve reliability and strengthen/upgrade the electric system. These
17 actions do not increase the number of customers, and therefore revenue; they only
18 increase costs.

19 **14. Q: Should revenue stabilization mechanisms reduce the Company's ROE?**

20 **A:** No. In general, revenue stabilization mechanisms, such as decoupling,
21 encourage utilities to promote energy efficiency and address declining sales but
22 do not address the Company's significant reliability-related investments financed
23 by shareholders and bondholders. As detailed in Company Witness Hevert's

1 Direct Testimony and his Schedule RBH-10, the majority of the proxy companies
2 used to determine the proposed ROE for Delmarva are using recovery
3 mechanisms and therefore decoupling will only increase the Company's degree of
4 comparability to the proxy group and reasonability for an ROE proposal of
5 10.75%. In addition, as detailed in Schedule RBH-11 of Company Witness
6 Hevert's Direct Testimony, the majority of the commissions have not made an
7 explicit ROE adjustment as a result of the implementation of decoupling
8 mechanisms. If the Commission finds that an ROE reduction is appropriate as an
9 offset for decoupling, Delmarva will have to consider withdrawing its application
10 to implement a decoupled rate design.

11 **15. Q: Has Delmarva Power provided empirical evidence that it has been**
12 **chronically under-earning?**

13 A: Yes. Delmarva has demonstrated a clear case of historical, chronic under-
14 earning, and shown that the current rate case approach cannot possibly provide
15 the Company with a reasonable opportunity to earn its authorized rate of return.
16 In fact, it is mathematically impossible for the Company to have an opportunity to
17 earn the authorized rate of return in this case based on the current rate case
18 process, because the growth in billing determinants between the test year and the
19 rate effective year cannot possibly cover the growth in rate base related operating
20 and capital costs, which are growing at a much higher rate.

21 **16. Q: If steps are not taken to remedy this situation what will happen?**

22 A: Without taking some action to correct this inevitable outcome, the electric
23 base distribution rates determined through the current rate case process are

1 outdated the day they are made effective, and therefore are not just and
2 reasonable. Absent the adoption of the RIM, this significant under earning of the
3 authorized rate of return will continue during the rate effective period.

4 **17. Q: Please describe the regulatory lag mitigation mechanisms that Delmarva**
5 **seeks in this proceeding.**

6 A: The Company is proposing that the Commission adopt two specific
7 regulatory lag mitigation mechanisms in this proceeding: (1) a RIM and (2) a
8 prospective change of Order No. 5410 that will allow use of fully forecasted test
9 periods. Company Witness VonSteuben quantifies the effect of the fully
10 forecasted test year.

11 Given the Company's current and upcoming high level of rate base
12 investment, Delmarva proposes that the Commission allow use of these two
13 mechanisms so that the Company's revenue will more closely match the costs
14 associated with providing service over the next few years. As discussed by
15 Company Witness Lowry, the RIM and the use of fully forecasted test periods
16 will help reduce the effects of regulatory lag while still producing results that can
17 be closely monitored by the Commission.

18 Delmarva has made and will continue to make significant investments to
19 strengthen and enhance the Company's infrastructure in order to reduce outages,
20 improve the level of service to our customers, and prevent deterioration in
21 performance. While necessary and beneficial for existing customers, the
22 investments do not relate to the connection of new customers, and consequently
23 do not produce additional revenue to recover costs associated with the investment.

1 The creation of a RIM and other measures discussed by Company Witness Lowry
2 will allow the Company to effectively recover costs that are mandated by
3 Delmarva's obligation to provide safe, reliable and adequate service to its
4 customers without the need to file frequent rate cases.

5 **18. Q: Rather than using a RIM, are there methods of deferring the higher capital**
6 **and operating costs (i.e. depreciation and property taxes) associated with the**
7 **non-revenue producing reliability projects between rate cases that would**
8 **prevent them from adding to the problem of chronic under-earning?**

9 A: Yes. Although far less desirable due to the cash flow and credit rating
10 implications, an alternative method of handling the under-earning problem would
11 be to use a process similar to the one authorized by the Commission for
12 Delmarva's AMI/smart grid expenditures, whereby the depreciation and other
13 incremental costs incurred between rate cases would be deferred into a regulatory
14 asset, earning a return at the authorized rate of return, and added to rate base for
15 purposes of cost recovery in a subsequent base rate case. The RIM will save the
16 customers the carrying charges associated with the regulatory asset and also
17 increase customer rates more gradually, thus protecting them from more
18 significant step rate increases. Moreover, this alternative, while significantly
19 helping to alleviate the chronic under-earning problem, will not alleviate the need
20 for the Company to continue to seek rate increases on a relatively frequent basis,
21 though possibly not as frequently as is needed under the current rate case process.

1 **19. Q: Is the Company's failure to earn its rate of return a recent trend?**

2 A: No. As shown in Table 1 of Company Witness VonSteuben's testimony,
3 the Company has not earned its authorized rate of return in Delaware for several
4 years. The shortfall in earnings necessary to earn the authorized rate of return due
5 to the timing difference between the test period and the rate effective period is due
6 to regulatory lag produced by current regulation.

7 **20. Q: What is causing the Company's inability to earn the authorized rate of**
8 **return?**

9 A: As I previously testified, the Company's revenues are not growing as fast
10 as the growth in its rate base-related costs and operating costs between rate cases,
11 despite efforts to control costs. Moreover, the use of an average rate base and a
12 partially forecasted test period, with only a few forward-looking adjustments,
13 does not adequately measure the level of costs likely to be incurred by the
14 Company during the rate effective period.

15 **21. Q: How important is the need to address regulatory lag?**

16 A: In order for Delmarva to continue to enhance and replace its infrastructure
17 and to supply safe and reliable service, the issue of regulatory lag must be
18 addressed. The increased spending requirement associated with the existing
19 infrastructure is common to many infrastructure replacement programs across the
20 country (e.g., other electric and gas distribution facilities, water systems, and
21 federal, state and local roads and bridges).

22 Moreover, AMI and distribution automation technologies that are now
23 available will enable Delmarva to provide more reliable service in a more

1 cost-effective manner while helping customers to save on the supply portion of
2 their bill. However, in order to replace and upgrade the existing infrastructure
3 and implement new distribution technologies, the Company will be required to
4 make substantial investments in its rate base.

5 It is more important than ever that the Company mitigate the impacts of
6 regulatory lag. If these negative impacts are not alleviated with the adoption of
7 effective regulatory lag mitigation mechanisms, the Company will never have a
8 reasonable opportunity to earn its authorized rate of return. It will not be able to
9 attract on reasonable terms the capital it needs to reliably serve its customers, and
10 will need to file for rate increases on a more or less annual basis over at least the
11 next several years, which, in the Company's view, is not in the Commission's or
12 any party's interest. Delmarva's ability to maintain its financial health is essential
13 to its being able to provide safe, reliable and efficient service to customers.

14 **22. Q: What are the adverse impacts of the regulatory lag?**

15 A: Without adequate recognition of the regulatory lag problem, and the
16 adoption by the Commission of mechanisms to offset it, Delmarva will continue
17 to under-earn its authorized rate of return for the foreseeable future. This
18 continual problem of under-earning is the reason for the Company's two
19 regulatory lag mitigation proposals as discussed by Company Witness Lowry.

20 Moreover, without adequate mechanisms to combat the effects of
21 regulatory lag, the Company will need to file rate increase applications at least as
22 often as annually over at least the next several years. Filing such frequent rate
23 cases, with all the attendant testimony, discovery, hearings and costs, is far less

1 efficient and much more time consuming and expensive than to institute effective
2 mechanisms to deal directly with regulatory lag. Moreover, in the Company's
3 view, the rate case process does not enhance the Commission's ability to
4 effectively monitor and regulate the Company. It is clear that the current rate case
5 practice and process are not achieving the goals they were designed to address.
6 Both are inadequate, expensive, inefficient, time consuming and produce
7 unreasonable results prospectively.

8 **23. Q: Is the Company presenting data to demonstrate the effect of regulatory lag**
9 **during the rate effective period?**

10 A: Yes. Company Witness VonSteuben presents testimony and Schedule
11 WMV-18 demonstrating that even if the Company is granted 100% of its rate
12 increase request, it will not have an opportunity to earn its authorized rate of
13 return during the rate effective period.

14 **24. Q: Please discuss options to mitigate regulatory lag.**

15 A: As Company Witness Lowry testifies, there are several precedents of other
16 regulatory commissions to support the mitigation of chronic under earning
17 resulting from regulatory lag through the use of various ratemaking mechanisms.

18 For example, at the federal level, FERC has authorized a formula rate
19 process whereby a company's transmission rates are updated annually without the
20 necessity of having a time-consuming and costly rate case process to reflect
21 current expenses and rate base investments based on a pre-set ROE. This process
22 provides utilities the opportunity to earn their authorized ROE without costly and
23 time-consuming rate case filings, and without sacrificing adequate oversight.

1 Customers can be spared the higher costs that result from frequent and protracted
2 rate case filings. Additionally, formula rates protect customers and the utility
3 from over and under recovery of the allowed ROE through a true-up mechanism
4 and protect customers from rate shock by making gradual changes to transmission
5 rates. These same principles can be applied to distribution rates.

6 At the state level, as described in the Direct Testimony of Company
7 Witness Lowry, several remedies for the regulatory lag caused by current
8 regulation are in widespread use. These include multi-year rate plans, fully
9 forecasted test years, formula rates, and expedited capex cost recovery. In
10 Louisiana, Mississippi, and Alabama, the state utility commissions allow the use
11 of formula rates for electric utilities while in Texas, South Carolina, and
12 Oklahoma, formula rates are used by gas utilities.

13 The use of any one or more of the options discussed by Company Witness
14 Lowry will not diminish the Commission's ability to regulate the Company.

15 **25. Q: Since the Company cannot fund its capital expenditure program solely with**
16 **internal funds, but rather must raise the needed funds in the capital markets**
17 **through debt borrowings and/or stock sales by PHI, is the investment**
18 **community concerned about regulatory lag?**

19 **A:** Yes. The investment community has significant concern; in fact
20 regulatory lag is the single most mentioned issue that investors bring up during
21 investor meetings with PHI in discussing the challenges faced by Delmarva and
22 the other PHI utilities. Since the beginning of 2011, the senior management of
23 PHI, including myself, has participated in 78 investor conferences and held 7

1 additional meetings with investors across the Country. In virtually every meeting,
2 investors and analysts consistently asked what the Company is doing and will be
3 doing to address regulatory lag.

4 The practical problem that regulatory lag causes is that investors view an
5 investment in PHI as more risky, because Delmarva's persistent inability to earn
6 the authorized rate of return means that the Company is not covering its costs and
7 is also more prone to negative credit rating actions. Over the long run, a company
8 that is viewed as more risky will pay more for capital, increasing its cost of
9 capital. During constrained markets, such as Delmarva has faced over the past
10 few years, the Company could experience limited access to needed funds. Both
11 of these problems will increase costs to the Company and cause a need for rates to
12 be higher in the future than they otherwise need to be. Moreover, it is important
13 that Delmarva and PHI be able to compete for capital under all capital market
14 conditions to be able to provide safe and reliable service to customers.

15 **26. Q: Is the investment community concerned about utility credit ratings?**

16 **A:** Yes. Maintaining investment grade credit ratings is critical to the financial
17 health of a utility and critical to its ability to access capital markets for financing
18 essential capital projects on reasonable terms and in all types of markets.

19 For example, in 2007, Ameren Corporation's credit rating was
20 downgraded by all three credit rating agencies; Moody's Investors Service
21 (Moody's), Standard & Poor's (S&P) and Fitch Ratings (Fitch). Moody's stated
22 with respect to the rating reduction, "The downgrade of parent company Ameren

1 considers the challenging political and regulatory environment facing the
2 company in both of its jurisdictions.”¹

3 Moody’s noted in reference to the downgrade of Ameren and its Illinois
4 subsidiaries, “. . .the increasing support for a rate freeze and the continued
5 political intervention in the utility regulatory process in Illinois has increased
6 credit risk for investors and is no longer supportive of investment grade senior
7 unsecured ratings.” In reference to its Missouri subsidiary, Moody’s emphasized
8 the downgrade was “prompted by higher costs at that utility, lower financial
9 metrics and a continued challenging regulatory environment in Missouri. . .”¹

10 Ameren, in its 2007 10-K filed with the U.S. Securities and Exchange
11 Commission (SEC), discussed the downgrade’s effect on its cost of borrowing,
12 “Interest expense increased \$73 million in 2007 compared with 2006, primarily
13 because of increased short-term borrowings, higher interest rates due to reduced
14 credit ratings, and other items . . .”² (Page 44)

15 Ameren’s cash flow was also negatively affected by the downgrade;
16 “Other factors also reduced cash flow: increased interest payments as a result of
17 lower credit ratings and increased debt.”² (Page 47)

18 In addition, the downgrade forced Ameren and its subsidiaries to make
19 prepayments and post collateral on certain obligations; “Collateral postings and
20 prepayments made as of the end of 2007 were \$56 million, \$5 million, \$8 million,
21 \$14 million, \$14 million, and \$21 million at Ameren, UE, CIPS, CILCORP,

¹ "Rating Action: Moody's downgrades Ameren & utility subs, ratings remain on review." Moody's Investors Service. 12 MAR 2007.

² Ameren Corp., December 31, 2007 Form 10-K (filed February 29, 2008).

1 CILCO and IP, respectively, resulting from our reduced issuer and senior
2 unsecured debt ratings.” (Page 60)

3 Ameren went on to discuss the downgrade’s effect on its ability to access
4 the capital markets; “Ameren and UE are currently limited in their access to the
5 commercial paper market as a result of downgrades in their short-term credit
6 ratings.” (Page 121)

7 Adverse credit actions, which can also lead to restricted access to the
8 capital markets, ultimately result in higher costs and therefore higher customer
9 rates. Moreover, under restricted capital market conditions, such as those that
10 occurred in 2008, lower rated companies are effectively shut out of the capital
11 markets, which can prevent obtaining the funds necessary for ongoing operations.

12 **27. Q: Are there examples where a utility’s credit rating was adversely affected by**
13 **regulatory lag?**

14 **A:** Yes. Hawaiian Electric Industries, Inc. (HEI) received a downgrade by
15 S&P on November 15, 2010 due in part to concerns about regulatory lag. In its
16 research update, S&P downgraded the company and its electric utility subsidiaries
17 of Hawaiian Electric Co. Inc. (HECO), Maui Electric Co. Ltd., and Hawaiian
18 Electric Light Co. Inc. to ‘BBB-’ from ‘BBB’. S&P explained, “Meanwhile, the
19 company’s capital and O&M expenses continue to climb. Regulatory lag and
20 disallowance of some costs has contributed to return on equity (ROE) that has
21 been below 6% in the last three years for the three utilities, and we do not expect
22 any material improvement.”³

³ "Rating Action: Hawaiian Electric Industries Inc. and Utility Subsidiaries Downgraded to ‘BBB-’ On Regulatory Lag, Weak Economy." Standard & Poor’s Ratings Service. 15 NOV 2010.

1 In its Form 10-K that was filed with the SEC after S&P's rating
2 downgrade, HEI explained the risks it faced from such rating downgrades: "If
3 S&P or Moody's were to downgrade HEI's or HECO's long-term debt ratings
4 because of past adverse effects, or if future events were to adversely affect the
5 availability of capital to the Company, HEI's and HECO's ability to borrow and
6 raise capital could be constrained and their future borrowing costs would likely
7 increase with resulting reductions in HEI's consolidated net income in future
8 periods. Further, if HEI's or HECO's commercial paper ratings were to be further
9 downgraded, HEI and HECO might not be able to sell commercial paper and
10 might be required to draw on more expensive bank lines of credit or to defer
11 capital or other expenditures."⁴ (Pages 28 & 29)

12 **28. Q: Do regulatory actions sometimes have a positive effect on credit ratings?**

13 A: Yes. In 2008, S&P upgraded the Ameren Illinois utilities' credit ratings
14 two notches from BB to BBB- based on its "assessment that the regulatory and
15 political environment in Illinois will be reasonably supportive of investment grade
16 credit quality with regard to their pending rate cases."⁵ Likewise, in the second
17 quarter of 2010, S&P upgraded Westar Energy's credit rating one notch to BBB
18 from BBB- when "the Company implemented multiple constructive rate orders
19 that supported base rates and reduced regulatory lag. . . "⁶ (Page 4)

⁴ Hawaiian Electric Industries, Inc., December 31, 2010 Form 10-K (filed February 18, 2011).

⁵ "Research Update: Ameren Corp's Illinois Subsidiaries Upgraded to Investment Grade." Standard & Poor's. 11 SEP 2008.

⁶ "EEI Q2 2010 Financial Update." Edison Electric Institute.

1 As discussed in the examples above, regulatory outcomes have a major
2 impact on utility credit ratings and can adversely, or favorably, impact the
3 financial health of the utility and the cost of providing service to its customers.

4 **29. Q: Please summarize your testimony in this case.**

5 A: Delmarva has a chronic under-earning problem because cost outpaces
6 revenue between rate cases and the current rate case process does not provide the
7 Company a reasonable opportunity to earn its authorized rate of return. Rates set
8 as a result of the current base rate case process are outdated and inadequate the
9 moment they are placed in effect. Unless these problems are remedied in the rate
10 setting process in this case, Delmarva will be required to file frequent rate cases
11 that result in litigating the same or similar issues every 9 to 12 months. Not only
12 is this process wasteful, it causes the Company difficulty in attracting capital on
13 the most reasonable terms.

14 The Company has proposed several mechanisms that will address this
15 regulatory lag problem without sacrificing the Commission's oversight
16 responsibilities. These proposals, if adopted by the Commission, will benefit all
17 concerned. Customers will be spared the cost of frequent and duplicative rate
18 case investigations and benefit from the likely lower cost of capital, and the
19 Company will benefit by having to direct less attention and resources to the
20 litigation of frequent rate cases and more attention and resources to managing the
21 delivery of electric power and making the needed investments to its infrastructure.

1 The investments that Delmarva makes in its distribution infrastructure
2 directly affect citizens of Delaware – our customers, our employees, and our
3 shareholders.

4 **30. Q: Does this conclude your testimony?**

5 **A:** Yes, it does.